

Policing the State

By Devala Janardan, Associate Counse

In January 2010, the Securities and Exchange Commission (SEC) created five new units dedicated to "particular highly specialized and complex areas of securities law."[1] The purpose of one unit, the Municipal Securities and Public Pension Unit (MSPP), is to focus on "misconduct in the large municipal securities market." On August 18, the MSPP surprisingly issued a cease-and-desist order, not to a corporation, but to the state of New Jersey for securities fraud.

The SEC Order[2] charges New Jersey with violating Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933.[3] Section 17 states: (a) It shall be unlawful for any person in the offer or sale of any securities or any security-based swap agreement... by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly - (1) to employ any device, scheme, or artifice to defraud, or (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading; or (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.[4]

The situation concerns two New Jersey pension plans, the Teachers' Pension and Annuity Fund (TPAF) and the Public Employees' Retirement System (PERS). These two plans are New Jersey's largest, with TPAF and PERS having actuarial assets of $34 billon and $28 billon, respectively. Assets include contributions by employers and plan members, and investment returns. Liabilities under these plans include benefits owed to retired plan members and administrative expenses for each plan. State law requires actuarial evaluations periodically. In 2001, TPAF had a "funded ratio"[5] of 108 percent and PERS had a funded ratio of 112.5 percent. In 2009, the funded ratio decreased significantly to 63.8 percent for TPAF and 56.4 percent for PERS.

What happened? In 2001, the State increased retirement benefits for employees and retirees enrolled in TPAF and PERS by over 9 percent. In order to fund these benefits, the State conducted a mark-to-market revaluation of the funds' assets, in order to reflect the "full" market value of the investments in the bull market. The State created new "benefit enhancement funds," that essentially set aside the difference between the increased revalued amount and the original valuation, in order to pay for the enhanced benefits to retirees. Bond offering documents did not disclose this new fund until 2003.

In 2004, the thread unraveled. The State was faced with a declining funded ratio and in response, a five-year plan was announced to put the State back on track to making its full statutory contributions. Unfortunately, rather than making real contributions to the funds, the State simply transferred funds from benefit enhancement funds, which although it gave the appearance that the State was making contributions, it was simply a transfer back to its original source. In 2005, the State Governor created a task force to audit employee benefit plans. The task force issued a critical report, specifically about the way funds were being misallocated; however, this report was not included in any bond offering documents. The situation deteriorated even further, as the State abandoned the five-year plan in 2005. This also was not disclosed in any bond offering statements.

From 2001 to 2007, New Jersey issued almost 80 different municipal bond offerings totaling $26 billon. While official offering statements for each offering contained information which included general information about State finances, the pension plans, and actuarial value of assets and liabilities for the previous six years, it did not contain material information about the use of benefit enhancement funds. The New Jersey Treasurer signed a Rule 10b-5 certification, certifying that the official statements did not contain any material misrepresentations or omissions. In its Order, the SEC charged that this failure to disclose gave the false impression that the plans were fully funded, and allowed the State to bypass its own law in not making contributions to the pension plans.

Fortunately for New Jersey, the Order by the SEC ends in a whimper, not a bang. The SEC considered the cooperation by the State during the investigation and accepted the remedial acts taken in anticipation of SEC action as sufficient action by the State. This included measures by New Jersey to implement formal, written disclosure policies, establishing a committee to oversee the disclosure process, and to conduct an annual mandatory training program conducted by disclosure counsel for employee's involved in the disclosure process. The SEC did not impose any additional sanctions and warned the State not to conduct any future violations. It seems that, at this point in time, the SEC is more interested in sending the strong message that states and localities must reevaluate their offering statements and comply with disclosure requirements.

Notes

1. Press Release, Securities and Exchange Commission, *SEC Names New Specialized Unit Chiefs and Head of New Office of Market Intelligence* (Jan. 13, 2010) (on file with author).
2. Order Instituting Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, Exchange Act Release No. 9135, Administrative Proceeding File No. 3-14009 (Aug. 18, 2010).
3. 15 U.S.C. §77(a) *et seq.* (2006).
4. *Id.* at §77(q)(a).
5. "Funded ratio" represents the actuarial value of assets divided by the actuarial liability of a plan. In short, a value of over 100 percent means that a plan is fully funded, where a plan of under 100 percent forms an "unfunded actuarial accrued liability." ML